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Chapter I

The world economy in 1999

After two years of financial turbulence and a marked slowdown in global economic growth, the world economy is no longer weakening. Led by the easing of monetary policy in major developed economies since the autumn of 1998, economic prospects have improved and global financial markets have shown signs of stabilization. Most noticeably, financial contagion from the Brazilian currency crisis at the beginning of 1999 was contained and there has been some restoration of capital flows to a number of emerging markets. There has also been a rebound in the price of oil since early 1999. The international prices of other commodities, which experienced a sharp decline in 1997–1998 and were an economic setback to many developing countries, have also stabilized.

In spite of these short-term developments, economic growth in 1999 remains inadequate and markedly lower than at mid-decade, particularly for the majority of developing and transition economies (see table I.1). The outlook for the rest of 1999 and beyond suggests only a minor overall improvement; in a number of cases, the economic situation will continue to deteriorate. In the majority of countries, growth for the foreseeable future will fall far short of what is necessary to effect a substantial improvement in living standards and a reduction in the number of people living in poverty.

* The final version of the World Economic and Social Survey, 1999 will be issued as a United Nations sales publication.

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Table I.1.
Growth of world output and trade, 1981–1999
(Annual percentage change)

	1981–1990	1991	1992	1993	1994	1995	1996	1997	1998[a]	1999[b]
World Output[c]	2.7	0.9	1.9	1.5	3.1	2.7	3.5	3.4	1.9	2
of which:										
Developed economies	2.9	0.8	1.6	0.8	2.6	2.2	3.0	2.8	2.0	1¾
Economies in transition	1.5	-8.6	-10.5	-6.1	-5.1	0.6	0.7	2.4	0.2	-½
Developing economies	2.4	3.2	5.0	5.2	5.7	4.8	5.7	5.5	1.7	2½
World trade[d]	4.5	4.3	5.7	4.6	10.5	8.6	5.5	9.2	3.3	3½
Memorandum items:										
World										
Number of countries with rising per capita output	..	71	75	67	99	109	122	121	97	98
Number of countries in sample	..	129	143	144	144	144	144	144	144	144
Developing economies										
Number of countries with rising per capita output	..	56	59	51	64	72	81	77	55	63
Number of countries in sample	..	93	94	95	95	95	95	95	95	95
World output growth with PPP-based weights[e]	3.1	1.4	2.1	2.5	3.6	3.6	4.1	4.1	2.4	2¾

Source: UN/DESA.

Note: Two dots (..) indicate that data are not available.

[a] Partly estimated.

[b] Forecast, based in part on Project LINK.

[c] Calculated as a weighted average of individual country growth rates of gross domestic product (GDP), where weights are based on GDP in 1993 prices and exchange rates.

[d] Average of the growth rates of the volume of exports and imports.

[e] Employing an alternative scheme for weighting national growth rates of GDP, based on purchasing power parity (PPP) conversions of national currency GDP into international dollars (see introduction to annex: statistical tables).

In 1998, output per head rose, despite the slowdown, in all developed countries except Japan and New Zealand. However, of the 95 developing countries for which reliable data are available, the number experiencing a decline in output per capita more than doubled from 18 in 1997 to 40 in 1998. About one person in four in the developing world, roughly 1.2 billion people, lived in countries that suffered a decline in per capita output in 1998. This compares with less than 4 per cent of the population of developing regions, 160 million people, in 1996. Moreover, for developing countries, even rising output per person is a minimal growth criterion. A growth rate of output per capita of 3 per cent, if sustained, is of the order of magnitude that would allow some progress to be made in raising living standards and reducing poverty. Whereas 39 developing countries met that criterion in 1996, only 23 did so in 1998. Forecasts are that only 13, including China, will meet it in 1999: 1 in Latin America, as opposed to 9 in 1996; 6 in South and East Asia, as opposed to 13 in 1996; and 6 in Africa, as opposed to 14 in 1996 (see table I.2).

Table I.2.
Growth of per capita output in developing countries, by region, 1996–1999

	Number of countries monitored	*Decline in GDP per capita*				*Growth of GDP per capita exceeding 3 per cent*			
		1996	*1997*	*1998[a]*	*1999[b]*	*1996*	*1997*	*1998[a]*	*1999[b]*
Frequency of high and low growth of per capita output (number of countries)									
Developing countries	95	14	18	40	32	39	34	23	13
of which:									
Latin America	24	5	3	8	9	9	8	4	1
Africa	38	6	8	13	8	14	11	12	6
East and South Asia	18	0	3	10	5	13	12	6	6
Western Asia	15	3	4	9	10	3	3	1	0
Memo items:									
Least developed countries	40	12	9	17	14	11	9	7	3
Sub-Saharan Africa	31	5	4	10	5	12	9	9	6
Percentage of population									
Developing countries	95	3.7	9.8	26.7	19.2	73.8	72.1	60.5	53.3
of which:									
Latin America	24	8.2	3.1	55.1	54.4	34.9	37.6	22.1	1.7
Africa	38	12.3	24.3	42.3	24.4	27.5	27.6	24.0	9.7
East and South Asia	18	0.0	6.8	15.9	8.5	93.9	90.9	79.3	76.2
Western Asia	15	16.5	18.5	59.1	59.5	34.9	36.9	9.3	0.0
Memo items:									
Least developed countries	40	19.7	13.0	33.6	26.1	52.4	39.9	28.7	6.7
Sub-Saharan Africa	31	19.5	16.5	32.6	27.2	38.0	29.6	17.2	16.4

Source: UN/DESA, including population estimates and projections from *World Population Prospects: The 1998 Revision* (United Nations publication, Sales No. E.99.XIII.9).

[a] Preliminary estimates.

[b] Forecast, based in part on Project LINK.

These data demonstrate that adjustments in real economic sectors will take a much longer period of time to be implemented and to bear fruit than changes in financial and monetary indicators. Recovery in employment and in real wages, and reversing the social setbacks brought about by the economic crisis will trail well behind the resumption of output growth. Above all, changes in the economic structures of many countries and reforms of

the international financial system will be a protracted process. While there appears to be a consensus on the need for reforming the architecture of the international financial and monetary systems, progress to date has been limited. Without successful systemic reforms, the global economy remains highly vulnerable to future international crises.

The international economic environment

The difficulty of recovery in individual countries is aggravated by the unfavourable international economic environment that has evolved as a result of the disruptions of the past two years. World trade grew by about 3.5 per cent in 1998. This is the smallest increase of the decade and markedly less than half the rate of 1997. It resulted from the almost 5 per cent decline in imports of developing countries, mainly owing to the collapse of imports of the crisis countries of East Asia, and the 10 per cent import drop in Japan. The 1999 outlook is for import levels to begin to recover, albeit slowly, with import volumes rising 2½ per cent in the developing countries, and ¼ per cent in Japan (see table A.13).

The value of world trade in dollars fell in 1998. The fact that commodity prices, particularly of oil, plunged during the year negatively affected the export earnings, and therefore the import demand, of many economies. Africa's exports, for instance, declined by 15 per cent in nominal terms in 1998, while in Western Asia, the value of merchandise exports shrank by about 25 per cent.

In response to the agreement among world oil producers in March 1999 to reduce their output, by May 1999 international prices of oil had rebounded by over 50 per cent from their lows at the end of 1998. However, oil prices are expected to retreat in the second half of 1999, resulting in smaller improvement on average over the year. Prices of other commodities have not followed the surge in oil prices, but signs of stabilization and even recovery appeared in several markets during the first quarter of 1999. Overall commodity prices are expected to increase slightly in 1999–2000, but to remain below prices earlier in the decade.

Developments in international financial markets had an unfavourable impact on developing countries in 1998. These countries had received a net transfer of financial resources between 1991 and 1996, which enabled them to finance an excess of imports over exports. The crisis reversed this flow. In particular, the South and East Asian region, whose past growth had inspired confidence in its future and attracted foreign capital, was faced with a massive withdrawal of funds. Financial flows to the region declined from a net inflow of $31 billion in 1996 to a net outflow of over $110 billion in 1998.

Until the fall of 1998, monetary policies worldwide had been restrictive, and thus did not provide a stimulus to the global economy, the significant exception among major economies being Japan. Policy makers in the United States of America were focusing on the inflationary potential from stronger-than-expected growth and most European Governments and central banks were concentrating on achieving the convergence criteria, notably for inflation, interest rates and fiscal deficits, for entry of their economies into the monetary union due to be inaugurated in early 1999. During the same period, interest rates in many emerging economies surged in a fruitless attempt to maintain — and possibly to attract more — foreign capital and thus to stabilize their currencies. Facing the growing threat of a global deflationary spiral, central banks in the major developed economies, led by the monetary authorities — the Federal Reserve System or Fed — of the United States, started to ease monetary policy in the autumn of 1998. The Fed made three interest-rate cuts in October-November 1998, and most developed economies reduced interest rates

substantially. As recently as April 1999, the European Central Bank (ECB) cut interest rates by 50 basis points. Interest rates in some of the crisis countries, which had been declining since mid-1998, approached pre-crisis levels.

The exchange rates of many Asian emerging economies stabilized in 1998. In the crisis countries, currency depreciations in 1997–1998 ranged from 20 to 80 per cent. Countries hit by renewed turbulence in early 1999 succeeded in stabilizing their currency faster than anticipated. However, exchange rates for a majority of countries have remained at values far below their pre-crisis levels although a few recovered some of their value against the United States dollar. Similarly, after a temporary weakening caused by the Brazilian crisis, equity prices have rebounded in most cases, with some emerging equity markets having returned to price levels close to their all-time highs.

The limited magnitude and duration of the contagion effects of the crisis in Brazil in January 1999 suggest that stability was returning to world financial markets and that confidence in emerging markets was being rebuilt. One indicator of the improved financial situation was the spread between the yields of sovereign debts of the emerging economies and yields of Treasury bonds of the United States. As the spread between these two kinds of financial instruments moved downward in 1998, it indicated both renewed confidence by investors and lower external financing costs of emerging countries. Despite the reduction in interest rates for the majority of potential borrowing countries, these spreads remain higher than before the Asian crisis and act as a disincentive to borrow. More importantly, there continues to be some reluctance to lend to most developing and transition economies, almost regardless of the interest rate. One reflection of this reluctance is the increasing investment-saving gap in the United States, as measured by its high and rising current-account deficit. This gap has been filled by absorbing a significant proportion of world saving that could have been directed towards financing a higher level of capital formation in other countries.

Given a continuing reluctance of investors to lend outside of a few preferred countries, net capital flows to emerging markets seem unlikely to improve over their 1998 level of $70 billion, a substantially lower level than the peak at over $200 billion recorded in 1996. However, if global financial stability is maintained, net capital flows could increase in 2000, possibly making up about half the decline that occurred between 1996 and 1998. Meanwhile, competition among developing economies for capital inflows is expected to rise as the Asian economies recover.

This stabilization of financial markets in mid-1999, while welcome, does not signal that the requisite changes in the global financial architecture have been effected. However, easing of the sense of financial crisis in 1999 has allowed time for more systemic changes to be made, while the continuing effects of the devastation caused by the 1997–1998 crises have made the need for such reforms ever more apparent.

The setback in 1998

At less than 2 per cent, the growth of world output in 1998 was about half of that in 1997 (see table I.1). Growth in all groups of countries slowed down but the setback to the developing countries was greatest. Their average growth of only 1.7 per cent in 1998 was below that of the developed countries for the first time since the 1980s and contrasted markedly with the average growth of 5 per cent or more that they had achieved earlier in the decade. However, China and India were able to sustain rapid growth in 1998 and are

expected to continue to do so in 1999. Their continued economic success augurs well for the large proportion of the world's poorest who are citizens of these two countries.

Earlier prospects of improved aggregate growth in the economies in transition evaporated in 1998, largely as a result of the crisis in the Russian Federation. Total output in these countries as a group was almost unchanged in 1998 but economic performances varied widely across countries: for example, Azerbaijan grew by 10 per cent but Romania, for the second year in a row, declined by some 7 per cent. As in 1997, 5 of these 26 economies recorded a fall in per capita output.

In contrast with the developing and transition economies, all the developed countries, with the exception of Japan and New Zealand, maintained or slightly increased their output in 1998. Growth in the United States exceeded expectations and Japan fell into a severe recession. Both developments had important implications for the world economy at large. The United States functioned as the main — and almost the only — engine of growth in the world economy, while Japan's difficulties dampened prospects elsewhere but particularly in the East Asia region where economic stimulus was most needed. Japan's recession and its banking crisis have been mutually reinforcing, showing that the banking crisis would have to be addressed in order to resurrect the economy.

The pattern of output growth across nations is widening the disparity between levels of living and personal incomes in the developed countries and those in the rest of the world. In order to narrow the gap between rich and poor countries, output per capita in the latter group has to increase faster than in the former.[1] Since the Asian currency crisis, the opposite has occurred. Moreover, the prices of exports produced by developing and transition countries have fallen relative to those for the goods produced by the developed world. This shift in relative prices over the past two years has amplified the deterioration in the position of the average person in the developing and transition countries: not only has average output fallen, but average incomes have fallen even more.

In contrast, and with the currently *sui generis* exception of Japan, the average consumer in the developed world has not been adversely affected by the international financial crises of the last two years. Overall economic growth has slowed, but output per capita has continued to increase and, because of the changes in relative prices mentioned above, real incomes have increased even faster than real output. Individual consumers in most developed countries have benefited directly from lower prices for primary commodities and for imports of a number of manufactured goods.

In addition to the increased income gap, developing countries and the economies in transition have to confront the social consequences of the financial crises they experienced. In social terms, what the crises have done is to delay or push back the movement of people from poverty into the more modern commercial sectors. An increase in the numbers entering formal employment, paying taxes to the government, obtaining loans from the financial system to expand their businesses and thereby providing employment opportunities to those currently in the informal sector should have been the result of continuing liberalization and globalization. Yet the financial crises in Asia and in the Russian Federation have put at risk the continued expansion of the more modern sector in these countries. Thus, whereas in recent years many of the developed countries were able to take advantage of globalization, the effects on many developing and transition countries have been perverse. The vulnerability of their economies meant that an external shock set back and even reversed their efforts to foster the expansion of the modern sectors at the very point when they seemed

[1] Because population growth is faster in poor countries than in rich ones, there has to be an even larger difference between the rates of increase in total output in the two groups of countries.

set to take fuller advantage of their integration in the global economy. The personal tragedy of those thrown out of work and reduced to poverty by the present crises represents a severe setback for development efforts at a broader level, impacting on a much larger number of people.

The near-term outlook: slower growth in many developing and transition economies

Despite the return of a degree of stability to world financial markets, the short-term outlook for the real economy remains poor, particularly by the standards of three years ago. Gross world output is forecast to rise only 2 per cent in 1999, growth being almost the same as in 1998, and is expected to increase by only 2½ per cent in 2000.[2] Not only is this pace of expansion far from satisfactory for many countries, but in addition some serious downside risks remain.

Growth in the developing economies is expected to recover only gradually from the sharp deceleration in 1998 and reach rates of 2½ and 4½ per cent in 1999 and 2000, respectively. Although a number of afflicted developing countries and transition economies show signs of a slow recovery, others are expected to remain in, or to enter, economic recession. The recession that swept over several countries in South-East Asia in late 1997 and 1998 hit a number of Latin American countries in late 1998; and it is expected to persist in 1999 but to moderate in the course of the year, with growth returning in 2000.

The South-East Asian developing countries have begun to recover from their financial crises but none is likely to return in the near future to the high growth rates achieved before the crisis. China's growth is expected to decelerate, but to remain in the 7–8 per cent range. India's strong growth should continue. African developing countries are expected to grow by about 3 per cent on average but, because of the relatively fast growth of population, substantial gains in per capita output are unlikely. In the Caribbean and Central America, several countries will have to overcome the damage inflicted by El Niño and severe hurricanes in 1998. Latin America as a whole is experiencing a recession in 1999 owing to adjustment measures in Brazil and other countries.

The outlook for growth in the economies in transition remains discouraging (see table A.3). Even with a recovery in oil markets, Kazakhstan, the Republic of Moldova, the Russian Federation and Ukraine are expected to see their gross domestic product (GDP) decline in 1999. Elsewhere in the Commonwealth of Independent States (CIS), the outlook is very mixed. In the Baltic countries, the pace of growth is likely to slow to under 2 per cent from about 4 per cent in 1998. The economies of Central and Eastern Europe, including those that were performing well, in particular Poland, are also likely to see a slowdown. Output in the Czech Republic and Romania is expected to continue to fall and Croatia and Slovakia could also go into recession. The confrontation over Kosovo and its aftermath will have a marked negative impact on neighbouring countries.

[2] The outlook reported in the present *Survey* is partly based on Project LINK, an international consortium of global economic forecasts and policy analysis supported by the Department of Economic and Social Affairs of the United Nations Secretariat. Documentation of detailed forecasts and the policy assumptions can be found in the various reports prepared for the spring LINK meeting, which was held in New York, 3–6 May 1999. These documents are available on the Internet (http://www.un.org/esa/analysis/link).

Inflation is likely to remain subdued in most developing and transition economies. However, some of the countries that experienced large currency devaluations are likely to experience higher inflation, in a process of adjustment to the overshooting in the depreciation of their real exchange rates.

Unemployment in most developing countries and economies in transition has worsened as a result of the recession or slowdown in these economies. This holds even for the economies in transition where the unemployment rate, which had soared rapidly during the first years of their transformation process, began to fall when the recovery finally started gaining momentum (see table A.7). Given the magnitude of the problem and since recovery in labour demand as a rule lags the recovery of output growth, the unemployment problem in these countries will remain for at least several years.

The outlook for the developed economies as a group is that, on average, they will grow at about 2 per cent in 1999 and 2000, almost the same rate as in 1998. They will continue to enjoy low inflation.

The United States is expected to register growth of 3½ per cent in 1999, after growth of nearly 4 per cent between 1996 and 1998 (see table A.2). The long stretch of expansion has brought unemployment close to 4 per cent, yet at the same time inflation has fallen to about 2 per cent. The key policy concern of the United States is how to avoid a "hard landing" for the economy in the face of stretched labour markets, a marked appreciation of stock prices, and record external deficits.

In spite of several substantial government stimuli, Japan's GDP declined by 2.9 per cent in 1998. The baseline forecast, drawn up in May 1999, was that the Japanese economy would contract by 1.4 per cent in 1999. However, the very strong preliminary estimates of growth in the first quarter of 1999 (released in June 1999) mean that, even if output were to remain flat for the rest of the year, Japan's economic growth in 1999 would be 0.9 per cent. The difference in over 2 percentage points in Japan's forecast growth would have major implications for the world economy, and especially for Japan's neighbours (as examined in box I.1).

Box I.1

Global consequences of a rebound in Japan

In the baseline outlook, which was based on information available as of the end of April 1999, a mild recovery in Japan's economy in the second half of 1999 was forecast, although gross domestic product (GDP) for the year as a whole was expected to contract owing to the decline expected in the first half. However, information in June 1999 suggested a stronger-than-expected rebound of the Japanese economy in the first quarter of 1999, after five consecutive quarters of decline. GDP growth of 1.9 per cent in the first quarter (or 7.9 per cent at an annual rate) was supported by a recovery in domestic demand, including a 1.2 per cent growth in private consumption, 1.2 per cent growth in residential investment and 2.5 per cent growth in business investment. Although there are concerns about the data-consistency of this preliminary estimate and even more concerns about the sustainability of this recovery — as indicated by a further decline in some industrial activities in April — there is a greater probability than before that Japan may register mild growth for 1999, rather than a further contraction.

Recovery in Japan would be not only important for Japan, but also crucial for supporting global growth, especially for boosting the recovery of the crisis-affected developing economies in Asia. A quantitative indication of this can be derived from the models of Project LINK. In a simulation using the LINK models, it was assumed, partly for simplicity, that Japan's GDP will register an average quarterly growth of zero for the remaining three quarters in 1999, implying annual GDP growth of 0.9 per cent for the year. This represents a 2.3 percentage point improvement from the forecast rate of growth.

Based on this more optimistic outlook for Japan, world output growth for 1999 would increase by 0.4 percentage points from the baseline, with world export volume increasing by 0.5 percentage points (see table). While GDP of the developed economies would rise by 0.6 percentage points (reflecting Japan's own contribution to the total, as well as the benefit of trade impulses on other countries), GDP for developing countries would increase by 0.2 percentage points. GDP in South-East and East Asia will be lifted noticeably because of the strong trade and financial links: for example, 20 per cent of Japan's imports come from the region. The Republic of Korea, in particular, would have an additional 1 percentage point of GDP growth in 1999, while the GDP of Indonesia would shrink by 0.6 per cent less than forecast.

Effects on output of a strong recovery in Japan

	Growth rate for 1999 under scenario (annual percentage change)	*Change from the baseline forecast (percentage points)*
World	2.4	0.4
Developed economies	2.4	0.6
Japan	0.9	2.5
Developing economies	2.8	0.2
China	7.7	0.2
Indonesia	-1.9	0.6
Republic of Korea	4.5	1.1
World export volume	4.0	0.5

Source: UN/DESA, based on Project LINK.

In the last quarter of 1998, largely because of a reduction in output in Germany and Italy, Europe experienced a deceleration of growth which is expected to persist into 1999. The slowdown, however, will be short-lived, in part because of the cut in interest rates in April 1999, together with buoyant consumer spending. Growth should be stronger in the second half of 1999 and so overall growth of 2 per cent in 1999 is likely to accelerate to 2½ per cent in 2000.

The unemployment picture in the developed countries reflected their growth performance (see table A.7). The unemployment rate in the United States has fallen to a level not observed since the late 1960s and is now lower than Japan's, which has been rising. High unemployment persists in many countries of the European Union, but depends only to a limited degree on the business cycle. While there was some improvement in recent years, especially in countries with the highest rates, such as Spain, rates are still above 10 per cent in many European countries. The reduction of unemployment continues to be a major policy issue for the European Union.

Major uncertainties

Even though stability appears to have returned to global financial markets and the world economy, the past two years have demonstrated that globalization has increased the uncertainties and downside risks faced by individual countries and the world economy. These risks themselves are not necessarily associated with a group of countries; they can stem from a national problem that, because of today's integrated world economy, has global consequences. The above forecast should thus be understood as subject to errors that could produce slower or faster growth than the forecasts show, albeit with a preponderance of downside risks.

One downside risk, possibly the worst, is that of a hard landing for the United States, either because of a stock market crash, which would reduce the wealth of economic actors, or because the authorities reacted to a sign of inflationary pressures by tightening monetary policy so sharply as to produce a decline rather than a moderate deceleration of output growth. What has hitherto been the main stimulus to world output could therefore go into reverse.

Among developing and transition countries, there are several downside risks: Brazil still faces a formidable task in addressing its large fiscal-sector imbalances; growth in China's export sector is declining faster than expected and consumer demand is also weak; there is a risk of a further decline in output in the Russian Federation, especially given the uncertainty surrounding the Government's economic policy and whether it will be able to achieve the required cutbacks in fiscal expenditures, increases in fiscal revenues, and structural reforms in the real and financial sectors. Setbacks in Brazil, China or the Russian Federation would have adverse consequences primarily for their neighbours and trading partners.

In order to examine one specific set of these downside risks, a study was undertaken, utilizing the models of Project LINK, of the possible impact on the world economy of another major financial crisis, on this occasion entailing a sizeable stock market correction and credit rationing, with currency realignments and shrinkage in international capital flows. The results (see box I.2) suggest that such a sequence of events would set off a severe contraction not only in developed countries but also, through their trading and financial links, in developing and transition economies. While the orders of magnitude in such a scenario depend on the assumptions made, the results indicate that world growth would slow down markedly and be accompanied by a further contraction in global trade. The impact on developing countries would be particularly pronounced. Because of the intensive trading and financial links between many of the economies in transition and the European Union, the former would experience a sharp drop in their growth rates as well.

Box I.2
The implications of another financial crisis

The present simulation examines the outcome of another financial shock, this time originating in the developed countries. The assumed shock takes the form of a decline in equity markets in the United States of America and Europe of 40 per cent from their peaks. Although this would be double the relative decline experienced at the height of the financial crunch in the fall of 1998, such a drop would bring the price-earnings ratio down to about its historical average. It is assumed that the collapse in equity prices would cause institutions such as hedge funds to fail, leading to a surge in corporate interest rates. An increase of 200 basis points in the yield spreads between corporate bonds and United States Treasury notes is posited. It is also assumed that the public rescue fund for banking reform in Japan will not have been fully successful in restoring the banks' lending capacities and that the fiscal stimuli are therefore less effective.

The impact on the emerging economies of such a severe contraction in the developed economies would occur through changes in international trade and capital flows. The meltdown of equity markets in developed economies would trigger a decrease of net capital flows to developing countries and economies in transition. Reflecting this, China is assumed to face a drop of $30 billion in foreign direct investment, which is about two thirds of the foreign investment it received in 1998.

The simulations indicate that a financial crisis of this nature would cause a loss of world output of 1.7 per cent over two years, relative to the baseline, and world trade would slow by 4.8 per cent in the same period (see table). The loss for the developed economies as a whole would be 1.6 per cent of their total gross domestic product (GDP) over two years. This would emerge through several channels. First, the equity-market meltdown would cause a drop in business confidence and in consumer sentiment which, through a self-fulfilling expectation process, would reduce both business investment and private consumption (particularly of durable goods). Next, a credit crunch would result in a higher cost for capital and this would impose another adverse shock on business investment.

Furthermore, as the credit crunch spread from corporate credit markets to consumer loans, private consumption would also be lowered. Finally, the large drop in asset prices would cause a fall in consumption owing to a wealth effect. Along with a decline in domestic economic activity, it is estimated that import demand in the developed economies would shrink by about 6 per cent over two years.

For the developing economies as a group, there would be a loss of 2 per cent of GDP over two years. Another financial shock would make it more difficult, if not impossible, for Asia and Latin America to recover. With the specific assumptions of a decline in foreign capital inflows into China and a devaluation of the yuan by 15 per cent to the rate that prevailed in unofficial markets in the summer of 1998, China's growth would drop to just above 3 per cent.

Gross domestic product and world trade
(Percentage difference from the baseline*)

	Year 1	*Year 2*
World	-1.2	-1.7
Developed market economies	-1.1	-1.6
Canada	-1.3	-1.8
France	-1.0	-1.2
Germany	-1.5	-2.2
Italy	-1.3	-1.4
Japan	-1.4	-2.2
United Kingdom	-0.5	-1.8
United States	-1.5	-1.8
Developing countries	-1.4	-2.0
Latin America	-1.1	-1.5
South and East Asia	-1.1	-1.6
China	-4.2	-5.8
World exports, volume	-3.1	-4.8

* See table I.1

Taking stock of policy after two crisis years

At the onset of the Asian crisis, the scale and form of the contagion that subsequently took place were not envisaged and the policy responses were correspondingly disappointing. The actions taken initially followed traditional approaches, with adjustments being made as shortcomings were exposed. However, even these adjustments were often a venture into the unknown.

The period since the crisis erupted has provided new experiences and a new perspective to economic policy-making at the national level. Because of the increased interdependence in the world economy, there has been a change in the balance between domestic and international considerations in many national policy choices. However, the differences among countries and in their degree of integration into the world economy suggest that, although there are some common elements, the optimal policy choices will depend on country circumstances.

In this era of heightened financial volatility, the importance of sound macroeconomic fundamentals has become paramount: a sustainable fiscal position and current-account balance, a low or moderate rate of inflation, and consistency between the rate of inflation and the exchange rate are indispensable for any economy, as all economies are open (albeit to different degrees). Equally important, however, is the need for a number of structural and institutional conditions to be met in order to reduce the likelihood that growth will be interrupted by international or domestic financial crises.

The past two years have prompted much discussion about the desirable policies and targets for key macroeconomic variables, the actions necessary to avoid future crises and the trade-offs that have to be addressed in striking the correct balance in policy. In many

of these cases, experience to date provides no definitive answer to the debate, other than that the response is likely to vary from case to case.

Macroeconomic policy and financial crises

A first question concerns the desirability of raising interest rates to the heights that were reached in crisis countries. Some increase in interest rates is inescapable, owing to the exit of funds from domestic financial markets. In general, policy makers in the crisis economies faced a dilemma. When exchange rates began to depreciate, monetary tightening was viewed as a means of preventing a depreciation-inflation spiral and of discouraging further capital outflows. However, it was recognized that monetary tightening would also seriously weaken economic activity and have other negative effects. In the recent cases, nominal interest rates were raised to very high levels and often kept there for a long period, giving rise to unusually high real interest rates. Nevertheless, exchange rates plunged.

Advocates of the high interest-rate policy argue that it was necessary to restore international market confidence in order to stabilize exchange rates. Opponents argue that this policy was not based on sound theory or evidence. They have shown that circumstances exist, and these may have characterized the situation in the Asian economies in crisis, when raising interest rates weakens the economy and leads to further currency depreciation. As such, this policy may have caused an unnecessarily deep recession, besides failing to stabilize the exchange rate.

Moreover, neither monetary nor fiscal policy excesses were the source of the crises that erupted in the Asian economies in 1997. These crises were caused largely by financial problems in the private, rather than in the public, sector; fiscal balances in most of these economies were sound, having been in surplus for many years prior to the crisis. Nevertheless, the initial policy involved adopting tight fiscal as well as monetary policies. This policy was eventually relaxed when the economic recession turned out to be deeper and more widespread than had initially been anticipated. There now seems to be some agreement that the extent of the fiscal austerity initially pursued by these economies was inappropriate.

Much of the deterioration in fiscal positions in 1998 was beyond the control of Governments. For commodity-dependent countries, the decline of commodity prices in international markets in 1998 led to significant reductions in public revenues. While the losses were particularly acute in oil-exporting countries, lower prices for non-oil commodities adversely affected many countries, mainly in Africa, that rely on international trade in commodities as a source of fiscal revenues. More generally, the necessary compression of imports, combined with longer-term programmes of reductions in tariffs as a part of trade liberalization measures, reduced tariff revenue, an important source of fiscal revenue in many developing countries. In addition, the overall slowdown in economic activity that took place in most economies tended to lower other government revenues.

In the Asian cases, increasing the fiscal deficit was an appropriate response to the crisis. In 1998, however, the widening of fiscal deficits was one of the causes of the crisis in the Russian Federation and Brazil. In considering this difference, a distinction needs to be made between the cyclical and structural portions of a country's fiscal position.[3] In the Russian Federation and Brazil, the deficits were structural and were likely to persist unless

[3] For a discussion of alternative measures of the fiscal deficit, see *World Economic and Social Survey 1997* (United Nations publication, Sales No. E.97.II.C.1 and corrigenda).

there were major policy changes. In the Asian case, the deficits have been cyclical and appropriate in order to stimulate economic activity, as well as to enable Governments to address some of the social consequences of the slowdown, and are expected to disappear as recovery proceeds.

For countries that are integrated into the world financial markets, views regarding the likely behaviour of market participants now play an increasing role in the determination of a Government's fiscal options. This limits the room for manoeuvre that Governments have in using fiscal policy to address purely domestic policy objectives. Governments have to balance the perceptions of these markets with their own policy objectives and domestic political constraints. Because of the sensitivity of these markets, the costs of a loss of confidence and the time it takes to regain confidence, there is an inbuilt pressure on Governments to adopt restrictive fiscal policies. In 1998, Governments in most instances were under pressure to reduce fiscal deficits, despite the need to allow automatic stabilizers to take effect and possibly to complement them with an anti-cyclical relaxation of policy. In the Asian crisis countries, for example, it was only when the severity of the recession and its social consequences became apparent that fiscal packages involving tax cuts to prop up domestic demand and increased social expenditures were adopted. Elsewhere, in cases where the consequences of the crisis have been less severe, fiscal policy remains generally restrictive. However, as illustrated in the Asian cases, this may not be desirable domestically from either an economic or a social perspective. In the present era of slow global growth, it may also not be optimal from the perspective of the world at large.

Coordinated international measures to accelerate recovery

The international response to the crises in South-East and East Asia was essentially restricted to the provision of large-scale financial assistance intended to meet the crisis countries' short-term needs for international liquidity. As indicated above, this financial assistance was initially accompanied by restrictive policies in the countries concerned but no changes in policies elsewhere were deemed necessary to address the consequences of the crisis. The result of this approach was not only a dramatic contraction in the countries concerned but also a slowdown in growth in the rest of the world. Particularly in the light of the present poor short-term prospects for the world economy, it is of interest to explore whether the use of international measures, rather than reliance purely on domestic action, might have achieved a more positive outcome for the countries concerned and, at the same time, might have boosted global economic growth.

One possibility could have been an internationally coordinated plan to cut interest rates in the major developed economies and increase official transfers to the Asian crisis economies. There are four reasons for such a set of policy actions.

First, the past two years have demonstrated that it is counter-productive for the global economy as a whole to have the initial burden of adjustment borne chiefly by the crisis economies through a tightening of aggregate demand. It would have been preferable if all countries with room for stimulating domestic consumption (such as the European economies) had contributed to the adjustment effort. The major European countries adopted measures of this nature when they started cutting interest rates beginning in the last quarter of 1998 in response to fears of a slowdown in their domestic economies. To the extent that this slowdown was a consequence of the initial crisis, these measures were a belated and indirect response to that crisis; if they had been taken earlier, the slowdown in their economies would probably not have occurred. In addition, the cuts were not coordinated at the global level

(although they were coordinated within the Euro zone, even before it officially came into operation).

This presents a second reason for such measures, namely, that a coordinated interest-rate reduction would stabilize the differentials in interest rates among countries and would therefore be more efficient; it would also have fewer adverse side effects for the world economy than country-driven interest rate changes which largely ignore the impact on rates elsewhere.

Third, an external demand stimulus would have been more effective in promoting recovery of the Asian economies because an important part of the idle capacity that was created in these countries was oriented towards exports.

Fourth, an additional official transfer of resources from the developed economies to the crisis countries would have not only stimulated these economies, but also fed back positive demand impulses to the developed economies through trade and other links. Foreign demand could have provided a stimulus to domestic activity in cases where weak domestic demand has since proved resistant to stimuli.

Addressing the social and human dimensions

The policy measures adopted in response to the crises in the Asian countries, in particular, brought into sharp relief the need to ensure consistency between short-term economic objectives, such as financial stability, and longer-term social and developmental goals, such as the eradication of poverty and the development of human capital. In some instances, there may be no incompatibility between economic and social objectives but this is not necessarily the case. In the Asian crisis countries, the policies initially adopted to address the crises abruptly reversed much of the long-term progress that had been achieved in reducing poverty and improving social conditions. This experience underlined the need to ensure that the social dimension is integrated into the formulation of economic policies, so as to avoid treating any negative social effects as by-products to be addressed later.

Negative social consequences of economic policies can arise through a variety of channels. The prime example of this occurs when budgetary cutbacks introduced to restore macroeconomic stability undermine the ability to deliver health care and education and to provide safety nets (such as food subsidies for the poorest). However, monetary policy can also have social consequences; for example, tight monetary policy restricts the availability of credit, and this is likely to impinge more on small and higher-risk borrowers than on major enterprises. Higher interest rates may discourage new investment in productive capacity, thus negatively affecting prospects for increased demand for labour. On the other hand, one of the key objectives of restrictive policies is often to control inflation, and success in this area has direct benefits for the poor. In Indonesia, for example, inflation since the crisis has been a major source of the increase in poverty.

These social consequences of the crisis not only entail short-term human costs but also cut into the ability of the countries concerned to build up their human capital and lift their standards of living over the longer term. For example, both declining school enrolment and worsening nutrition among children reduce the potential of those individuals to contribute to the economic and social development of their societies over the longer term.

The international community has long accepted the principle that the social and economic dimensions of policy should not be treated in isolation. Implementing that principle, however, has proved elusive. It is now increasingly recognized that the response

to crises has to address the domestic social consequences of any economic measures that are adopted and should not be restricted to restoring macroeconomic stability and international financial confidence. Various social safety nets have been introduced in the crisis countries as a result. However, it has also become apparent that social protection mechanisms are more effective if they are in place before a crisis strikes than if they are hastily put together after a country faces a severe recession. The social dimension therefore needs to be incorporated in economic policy as a matter of course.

Strengthening the financial architecture

The crises of the past two years are attributable less to traditional macroeconomic imbalances than to vulnerabilities that arose from the way financial liberalization had been pursued and the phenomenal growth of private sector exposures to large amounts of risk which were underappreciated and not very well understood. The result has been widespread recognition of the need to devise new financial regimes which would be less susceptible to these types of crisis. This policy initiative has domestic and international dimensions and has come to be called "renewing the international financial architecture".[4]

As a first principle, it is universally accepted that the governance of financial markets and institutions must be strengthened in developed, developing and transition economies, albeit without assuming that one set of practices fits all situations. Private financial institutions need to be able to cope with volatility in the markets in which they operate. This means having capital adequate to their risk exposure and the capacity to monitor and manage their risk. The role of government is to establish incentives and sanctions that force financial firms in this direction. This entails strengthened regulation and supervision, bankruptcy and foreclosure laws, corporate transparency and governance.

These improvements require the development of human and institutional capital in most developing and transition economies, which takes time. For this reason, financial sector liberalization needs to be paced with the build-up of regulatory capacity and appropriate professional and managerial capacity in financial institutions. This implies that the appropriate pace of liberalization will be determined by the country's stage of development and capacity to make effective use of international expertise in both private and public sectors.

Governments need flexibility in considering the use of controls on movements of capital into and out of their economies, in particular as regards short-term flows. Views differ on the usefulness and effectiveness of different types of capital controls and no single model will be appropriate for all countries. Thus, the international community should not discourage countries from adopting policies to inhibit potentially volatile inflows and outflows. The experience of the past few years is an argument for experimentation and against dogmatism.

The damage that can arise when the uncertainty of private financial actors turns to fear and flight is much better appreciated than before. To lessen uncertainty, Governments and the International Monetary Fund (IMF) have worked recently to increase the amount of information in the public domain and the speed with which it is provided. International

[4] As a contribution to this project, the most senior officials of the United Nations Organization in the economic and social arena, through the Executive Committee on Economic and Social Affairs, prepared a set of proposals in a report entitled "Towards a new international financial architecture" (available on the Internet at www.un.org/esa/coordination/ecesa/eces99-1.htm).

organizations have also enhanced cooperation so as to provide more reliable information, such as on financial flows and debt, and to do so more quickly. These are important initiatives that need the support and participation of creditor and debtor countries, of Governments and the private sector.

The policy community has become sensitive to the expectations of international private creditors that they would be bailed out by the international public sector when currencies and banking systems of emerging market economies went into crisis. Those expectations caused excessively risky lending practices — the "moral hazard" problem — and huge bailouts (financed at market interest rates and substantial cost for most countries). The international community is seeking to develop mechanisms to involve creditors in the working out of a future crisis and to reduce moral hazard by asking creditors (banks and bondholders) to shoulder more risk. Beyond general principles, however, there is little agreement on mechanisms or instruments to effect this change. This is an important area for further work.

At the same time, the international community favours providing adequate liquidity to countries in crisis, especially when these countries have followed sound policies and are hit by contagion from a crisis that is spreading internationally. A step was taken in this direction in April 1999 when IMF agreed to establish the Contingency Credit Line. Countries that meet certain policy criteria will be able to arrange a line of credit at IMF from which they can draw on short notice in the event of a financial emergency stemming from international developments beyond their control. This is to supplement their primary line of defence, holdings of their own reserve assets.

Beyond these policy developments, there has been a new intellectual ferment in respect of trying to better understand how financial sectors operate. It is clear that the financial sector in developed countries has been evolving rapidly in recent decades, especially the banking systems. The liberalization drive in developing countries has plunged these countries into a new, highly competitive world of finance, as has the adoption of market-based financial systems in the economies in transition. Technology has so evolved that the uncertainties, asymmetries and market failures inherent in finance can wreak extensive damage with unprecedented speed, as we have been witnessing over the past two years. In order to help take stock of our understanding in this area, part two of the present *Survey* is devoted to an examination of financial development in the globalizing world.